THE ECONOMIC AND BUDGET OUTLOOK:

FISCAL YEARS 1988-1992

The Congress of the United States
Congressional Budget Office

NOTES

Unless otherwise indicated, all years referred to in this report are calendar years.

Unemployment rates throughout the report are calculated on the basis of the civilian labor force.

Details in the text and tables of this report may not add to totals because of rounding.

Figures showing periods of recession (indicated by a shaded area) reflect the peak (P) and trough (T) of the recession.

The CBO forecast was prepared in December 1986, and does not incorporate either the January 1987 revisions of the household employment survey data or the January 22, 1987 release of national income data for the fourth quarter of 1986.

The Balanced Budget and Emergency Deficit Control Act of 1985 is also referred to in this volume more briefly as the Balanced Budget Act.

PREFACE

This volume is one of a series of reports on the state of the economy and the budget issued periodically by the Congressional Budget Office (CBO). In accordance with CBO's mandate to provide objective and impartial analysis, the report contains no recommendations.

The analysis of the economic outlook presented in Chapter I and the analysis of economic growth in Chapter III was prepared by the Fiscal Analysis Division under the direction of William J. Beeman and Jacob S. Dreyer, with the assistance of Trevor Alleyne, John Canally, Suzanne Cooper, Robert A. Dennis, Victoria S. Farrell, Douglas R. Hamilton, George R. Iden, James Kiefer, Steve Parker, John F. Peterson, Martin A. Regalia, Frederick C. Ribe, Frank S. Russek, Jr., Matthew A. Salomon, John R. Sturrock, Eng Meng Tan, Helena Tang, Stephan S. Thurman, and Bragi Valgeirsson.

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Paul L. Houts supervised the editing and production of the report, assisted by Nancy H. Brooks. Major portions were edited by Patricia H. Johnston, Francis S. Pierce, and Sherry Snyder. Debra M. Blagburn coordinated the preparation of the report. The authors owe special thanks to Dorothy J. Kornegay, L. Rae Roy, Earnestine Miles, and Thelma L. Jones, who typed the many drafts. Additional assistance was provided by Shelbah Adams.

Rudolph G. Penner
Director

January 1987

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SUMMARY

Despite the record high federal budget deficit for fiscal year 1986, a continuation of current policy would imply substantially lower budget deficits in coming years. The Congressional Budget Office (CBO) projects that the baseline federal deficit will decline from $221 billion in 1986 to $174 billion in 1987, $169 billion in 1988, and $85 billion in 1992. In relation to gross national product (GNP), the deficit is projected to decline from 5.3 percent of GNP in 1986 to 3.6 percent in 1988 and 1.4 percent in 1992.

These budget projections are contingent on CBO's forecast of a moderate pickup in economic growth from its subdued pace in 1986, and a modest decline in both short-term and long-term interest rates over the projection period from their average levels in 1986. They also assume that current taxing and spending laws remain unchanged and that both defense and nondefense discretionary appropriations are held to zero real growth. The budgetary outlook and the economic assumptions underlying the forecast are presented in Summary Table 1.

The economic expansion has now entered its fifth year. Over the four quarters of 1986, the economy grew at a 2½ percent rate--about the same as in 1985 but substantially below its growth in the first two years of recovery. Unemployment in 1986 was slightly below that of 1985 but still averaged 7.0 percent. Total employment grew rapidly, however, by about 2.3 percent. Most of the new jobs were still in the service-producing sector. There was a continuing weakness in the goods-producing sector, at least partially attributable to the widening trade deficit. Inflation decreased in 1986, especially as measured by the Consumer Price Index (CPI), largely because of the precipitous decline in oil prices at the beginning of the year. Despite the continuing depreciation of the dollar against most other currencies, prices of imports did not move up as sharply as many forecasters had anticipated. Interest rates--especially long-term rates--fell considerably as a result of the easing of inflation, the sluggish growth of the economy, and the expectation of lower federal deficits.

CBO forecasts a moderate pickup in economic activity in 1987 and 1988. Real GNP is expected to grow just under 3 percent annually. Like most other forecasters, CBO anticipates that the trade sector will be the

SUMMARY TABLE 1. BASELINE BUDGET PROJECTIONS, DEFICIT TARGETS, AND UNDERLYING ECONOMIC ASSUMPTIONS

	Actual 1986 a/	1987	1988	1989	1990	1991	1992
Budget Projections (By fiscal year, in billions of dollars) b/							
Baseline Estimates							
Revenues	769	834	900	962	1,050	1,138	1,220
Outlays	990	1,008	1,069	1,124	1,184	1,247	1,305
Deficit	221	174	169	162	134	109	85
Deficit Targets	172	144	108	72	36	0	n.a.
Baseline Less Targets	49	30	61	90	98	109	n.a.
Economic Assumptions (By calendar year)							
Nominal GNP (percent change)	5.4	6.0	6.9	7.2	7.4	7.0	6.8
Real GNP (percent change)	2.6	2.8	3.0	3.0	3.1	2.7	2.5
CPI-W (percent change)	1.6	3.5	4.3	4.3	4.3	4.3	4.3
Civilian Unemployment Rate (percent)	7.0	6.6	6.5	6.3	6.1	6.0	6.0
Three-Month Treasury Bill Rate (percent)	6.0	5.6	5.7	5.6	5.5	5.3	5.2

SOURCE: Congressional Budget Office

NOTE: n.a. = not applicable.

a. 1986 data for nominal and real GNP and the CPI-W are CBO estimates. The estimates do not reflect the actual data for the fourth quarter of 1986, scheduled for release on January 22, 1987.

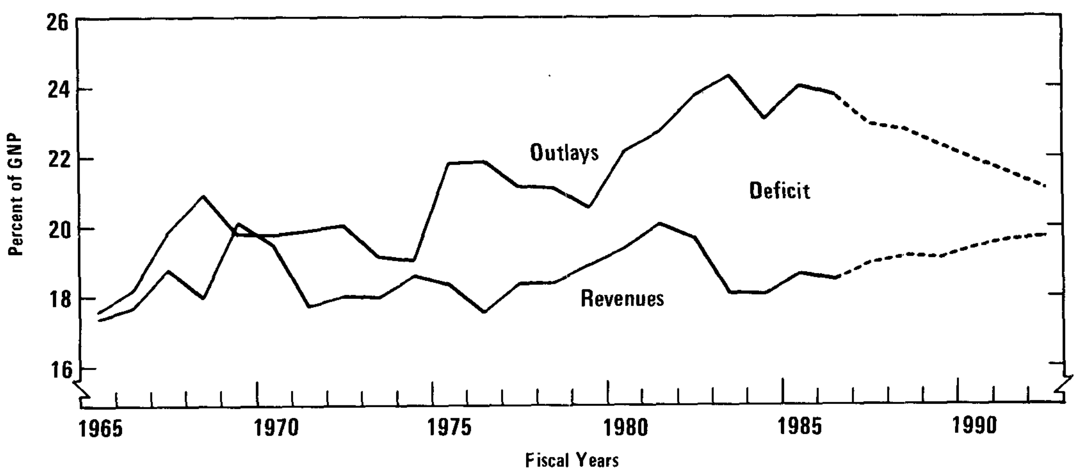
b. The baseline estimates and deficit targets include Social Security, which is off-budget.

major contributor to the stronger growth, which should bring unemployment down to an average of 6.6 percent in 1987 and 6.5 percent in 1988.

CBO's forecast calls for a fairly substantial rise in reported inflation, from 2½ percent in 1986 (as measured by the implicit GNP deflator) to about 3.7 percent in 1987-1988. On the consumer level, CBO sees inflation rising from the artificially depressed rate of 1 percent, to 1½ percent in 1986, to almost 4½ percent in 1987 and 1988. The rise in inflation will reflect, among other things, somewhat higher oil prices and rising import prices caused by the falling dollar. Interest rates in 1987 and 1988 are expected to average near their present levels.

Under these economic assumptions, CBO projects a sharp decline of the baseline budget deficit in 1987 and a further moderate reduction in 1988. About half of the expected decline in the 1987 deficit results from one-time factors, including an increase in revenues under the Tax Reform Act of 1986, asset sales, and shifts of outlays into adjacent years. After 1987, revenues under current laws are projected to grow at an annual rate of nearly 8 percent--slightly faster than GNP--while baseline outlays grow only 5 percent per year, which is substantially below the 10 percent annual growth rate experienced earlier in the 1980s and less than the projected growth in the economy (see Summary Figure 1).

Summary Figure 1.
Baseline Revenues and Outlays



SOURCES: Congressional Budget Office; Office of Management and Budget; Department of Commerce, Bureau of Economic Analysis.

Baseline budget deficits, although declining throughout the projection period, exceed by large amounts the targets established by the Balanced Budget and Emergency Deficit Control Act of 1985. The 1988 deficit would have to be cut $61 billion below the baseline in order to reach the goal of $108 billion. For fiscal years 1989 through 1991, the baseline deficit averages about $100 billion over the statutory targets (see Summary Table 1).

THE ECONOMIC OUTLOOK

Economic growth in 1986 turned out to be weaker than most forecasters had anticipated, mainly because of sluggishness in the manufacturing sector. Domestic demand remained fairly strong, growing about one percentage point faster than output. Growth of personal consumption, which accounts for about 65 percent of GNP, was faster than in the preceding year. Residential construction was also stronger than in 1985. Business fixed investment, however, contracted during the year. Most important, real net exports continued their rapid deterioration; the widening of the trade deficit accounted for the divergence between the fairly strong growth of domestic demand and the weak growth of output.

The difficulties in the manufacturing sector seemed to lessen toward the end of the year, as indexes of industrial activity began pointing toward better times ahead. The rebound in oil prices in the second half of 1986 helped stem the decline in activity in the oil industry and its suppliers, although higher oil prices will mean greater difficulties for the economy over the longer run.

While the trade picture at year-end remained bleak, there were some indications that import prices had begun to respond to the prolonged and substantial depreciation of the dollar against major foreign currencies. This rise in import prices suggests that the decline in real net exports is likely to bottom out in the first half of 1987. Prospects for other components of demand are less buoyant. Business fixed investment is expected to remain lackluster, while growth in consumer spending, residential construction, and government purchases of goods and services is expected to be slower in 1987 than last year.

CBO's economic projection consists of two parts: a short-term forecast of economic conditions through 1988 contingent on specific policy and other crucial assumptions; and a medium-term projection for the period 1989 through 1992 based on historical trends and other assumptions about economic growth.

The Forecast for 1987-1988

CBO's two-year forecast, presented in Summary Table 2, is based on the following assumptions as to fiscal and monetary policy:

- o Federal budget policies for fiscal year 1988 are assumed to be consistent with achieving the deficit targets specified in the Balanced Budget Act. Since the policies for that year are not known, CBO assumes equal across-the-board revenue increases and spending cuts, after incorporating an estimate for asset sales.

- o The Federal Reserve Board is assumed to pursue a policy that would allow the monetary aggregate M2 to remain within its target range.

SUMMARY TABLE 2. THE CBO FORECAST FOR 1987 AND 1988

	Actual 1985	Estimated 1986	Forecast 1987	Forecast 1988
Fourth Quarter to Fourth Quarter (percent change)				
Nominal GNP	6.3	5.1	6.5	7.1
Real GNP	2.9	2.5	3.0	2.9
Implicit GNP Deflator	3.3	2.6	3.4	4.0
CPI-W	3.2	1.1	4.4	4.4
Calendar-Year Averages (percent)				
Unemployment Rate	7.2	7.0	6.6	6.5
Three-Month Treasury Bill Rate	7.5	6.0	5.6	5.7
Ten-Year Government Bond Rate	10.6	7.7	7.2	7.2

SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics.

In addition, the forecast assumes that:

- o The world price of oil will be close to $15 per barrel through the end of 1988. 1/

- o The exchange rate (as measured by the Federal Reserve Board index) will continue to decline, reaching by the end of 1988 a level about 10 percent below its level at the end of 1986.

- o Food prices will rise by about 4 percent throughout the forecast period.

Given these assumptions, CBO expects real GNP to grow at about a 3 percent annual rate between the fourth quarters of 1986 and 1988. Inflation at the consumer level will rise in 1987-1988 to around 4½ percent from its exceptionally low level in 1986. But the increase as measured by the GNP deflator will be significantly less than as measured by the Consumer Price Index, primarily because import prices are excluded from the GNP deflator but not from the CPI. Civilian unemployment is forecast to average 6.6 percent in 1987, and to drop further in 1988 to around 6.5 percent. The interest rate on three-month Treasury bills should rise slightly in 1987 from current levels, while yields on 10-year Treasury bonds are expected to remain at their current levels.

Medium-Term Economic Projections

CBO's medium-term projections for 1989 through 1992 are not a forecast of economic conditions, but projections based on historical experience. These outyear economic projections are not predicated on specific budget policies, and may not be consistent with the budget policies now in place, nor do they assume any specific course of monetary policy. The major characteristics of the 1989-1992 projections are shown in Summary Figure 2.

- o Real GNP grows at an average rate of 2.7 percent.

- o Unemployment declines to about 6 percent in 1990 and remains near this level in subsequent years.

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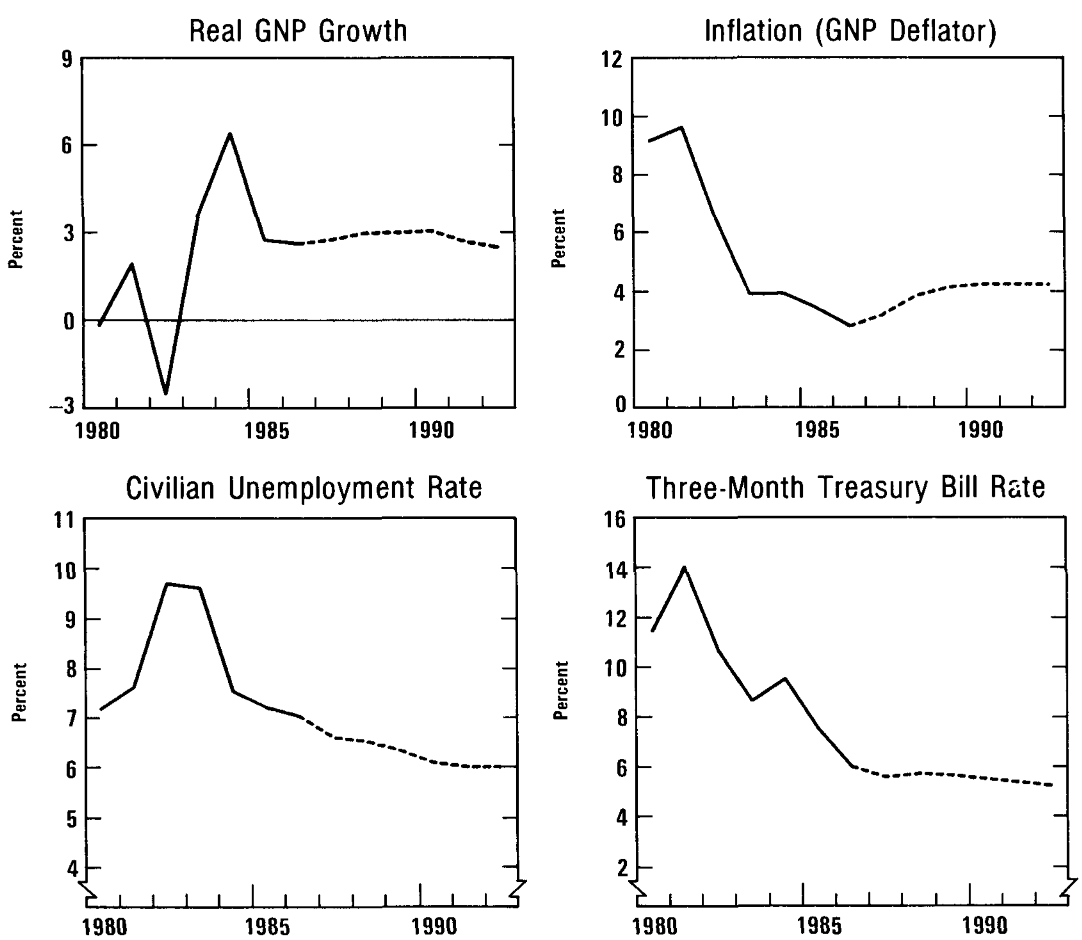
1. This assumption reflects the expectations of oil futures markets at the time the CBO forecast was completed in December 1986. Since then, as a result of an agreement by the OPEC countries to limit their production of oil, its price went up to the range of $18 to $19 per barrel. If these higher oil prices prevail, the CBO forecast will have understated the contribution of oil prices to higher inflation.

- o Inflation, as measured by the CPI-W, holds at 4.3 percent throughout the projection period.

- o Interest rates on short-term Treasury bills decline gradually to 5.2 percent by 1992, while rates on long-term Treasury bonds decline a bit more sharply to 5.6 percent by the end of the projection period.

Summary Figure 2.

Major Economic Assumptions



SOURCES: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.